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In the Supreme Court of the United States

OCTOBER TERM, 1957

SOUTH CAROLINA GENERATING COMPANY, PETITIONER

v.

FEDERAL POWER COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

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OPINIONS BELOW

The opinion and orders of the Federal Power Commission (1 R. 93–120, 135–139)[1] are reported at 16 F. P. C. 52 and 1365. The opinions of the United States Court of Appeals for the Fourth Circuit (Pet. App. A 1–30) are reported at 249 F. 2d 755.

JURISDICTION

The judgment of the Court of Appeals was entered on October 23, 1957. A petition for rehearing, timely filed, was denied on November 23, 1957. The petition for a writ of certiorari was filed on December 31, 1957. The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1).

[1] Petitioner filed the record in six volumes. Thus, 1 R. — refers to the first volume.

QUESTIONS PRESENTED

1. Whether the Federal Power Commission, acting pursuant to Section 206 (a) of the Federal Power Act, may reduce a contract rate when it finds that the rate is unjust and unreasonable on the basis of cost of service.

2. Whether the concept of a zone of reasonableness applies to the Commission's review of contract rates which are found to be in excess of the cost of the service (including a fair return on investment).

3. Whether there is substantial evidence to support the three findings that the Commission has been instructed by the court below to explain in greater detail on remand.

STATUTE INVOLVED

The pertinent provisions of the Federal Power Act, 49 Stat. 838, 16 U. S. C. 791a, *et seq*, are set out in the Appendix, *infra*, pp. 19–21.

STATEMENT

Petitioner, South Carolina Generatin ; Company, is a wholly-owned subsidiary of South Carolina Electric & Gas Company (E & G), which was formed for the purpose of financing the construction of Plant Urquhart steam electric generating station. In 1950, E & G, which distributes and sells electric energy within the state of South Carolina, was considering an addition to its generating capacity and was investigating possible sites for location of a steam plant. Before final plans were completed and a definite site chosen, the Atomic Energy Commission announced that its Savannah River Hydrogen Bomb

Project would be located in the vicinity of Aiken, South Carolina. Sensing the possibility of the addition of a major increase in demand in its market area, E & G entered into negotiations with E. I. duPont de Nemours & Company, as prime contractor for the Atomic Energy Commissions at Aiken, to supply electric energy to the installations at Aiken. Originally, E & G planned to construct the new capacity itself and made an initial offer to duPont based upon that assumption. However, the proposed rate was rejected by duPont as too high. Since lower rates would have been impossible under conventional utility financing and because of the restriction which existed on the amount of E & G's mortgage indebtedness, E & G formed petitioner, a wholly owned subsidiary having a capital ratio of 90 percent debt to 10 percent common stock, the stock being held by E & G. This high debt financing provided money at a low cost and made possible lower rates to duPont, which agreed to accept a capacity of 30,000 kw. (1 R. 94–95).

Prior to the construction of the Urquhart plant, the Georgia Power Company, which had been contemplating additions to its own generating system, found that it could save money by purchasing power (capacity) and energy from petitioner instead of building an additional plant of its own. Accordingly, it entered into a twenty-five year contract with petitioner by the terms of which petitioner undertook to furnish, and Georgia Power agreed to purchase, one-half of the capacity of the two 75,000 kw units

to be installed by petitioner at Urquhart. The remainder of the capacity was sold to duPont and E & G, 30,000 kw to duPont and 45,000 kw to E & G (1 R. 95–96). Only the sale to Georgia Power is subject to Federal Power Commission jurisdiction.

Petitioner's contracts with its three customers, Georgia Power, E & G, and duPont, contain similar provisions but varying rates. Each contract provides for a two-part rate consisting of an energy charge and a capacity charge. The energy charge, about which there is no dispute, is based on fuel and maintenance costs plus taxes not related to income. The capacity charge in each case includes a basic rate of $15.30, subject to escalation. This $15.30 charge includes a component of $10.50, representing interest, amortization of the debt and return at 8 percent on equity; and a component of $4.80, representing expenses related to the ownership of the Urquhart Station. To this basic $15.30 charge there is added a fixed charge of $7.20 per kw in the Georgia Power contract, a fixed charge of $3.70 in the duPont contract, but no additional charge in the contract with the parent company, E & G. Thus, the original capacity charge to Georgia Power was $22.50 per kw, to duPont $19.00 per kw, and to E & G $15.30 per kw. As adjusted to reflect increased plant cost in accordance with escalation clauses in each contract, petitioner estimated that for the test year 1956 the capacity charge would be $25.31 for Georgia Power, $21.81 for duPont, and $18.11 for E & G. (1 R. 96–97).

The $7.20 added to the capacity charge in the rate fixed by the contract with Georgia Power does not relate to any costs incurred by petitioner but was designed to divide between petitioner and Georgia Power the estimated savings to Georgia Power from the agreement, as compared with the construction and operation of a generating station of Georgia Power's own, the estimated saving being about $600,000 per year. The Federal Power Commission also noted that, although duPont pays less per kw of capacity than Georgia Power, duPont receives superior service which costs more to provide (1 R. 97–98).

After petitioner's contract with Georgia Power was filed as a rate schedule with the Federal Power Commission, the Commission undertook an investigation to determine whether this contract rate was unjust, unreasonable, or unduly discriminatory (1 R. 94). The Commission held that the reasonableness of the rate should be determined by cost of service to the utility and not by the value of the service to the purchaser (1 R. 98–102). On the basis of its findings as to the cost of service to petitioner, the Commission found that the contract rate for service to Georgia Power was in excess of a just and reasonable rate by $252,186 annually, and was unjust and unreasonable. Accordingly, it ordered that petitioner's capacity charge to Georgia Power be reduced from $25.31 per kw (or $1,898,300) to $21.95 per kw (or $1,646,114), a difference of $252,186 per year (1 R. 116–117). It also ordered that the escalation pro-

visions in the capacity charge be eliminated for the future, except with respect to increase or decrease in the federal income tax rate (1 R. 117).

On petition for review of this order, the court below unanimously held that the entry of the Commission's order based upon cost of service, and without reference to the value of the services to the purchaser, was within the power of the Commission. The court also found that the record supported the Commission's action allowing a rate of return of 5.55 percent rather than the 6 percent sought by petitioner, and a depreciation allowance of 2.75 percent instead of the 3 percent sought. But the majority of the court found that the Commission had failed to explain three findings in sufficient detail and ordered the proceeding to be remanded to the Commission. The court thought the Commission should explain why it used petitioner's actual capitalization ratio in determining its income taxes while using the capitalization ratio of the entire E & G system in fixing the rate of return on investment. The Commission was also instructed to explain its reasons for eliminating the escalation provisions from the basic capacity charge and for allowing interest of only 6 percent for the use of equity funds during construction. Chief Judge Parker, finding that the Commission had not abused its discretion in any respect, voted to affirm the Commission's order in its entirety.

ARGUMENT

1. Petitioner urges that, because it entered into a rate contract with the Georgia Power Company at arm's length, the Federal Power Commission is without authority to change these contract rates without finding that the rates and charges to the purchaser (Georgia Power) are so high as to impair its financial ability to render service to its customers, to cast an excessive burden on its customers, or to be unduly discriminatory. As was found by both the Commission and the unanimous court below, this contention is based on a totally unwarranted interpretation of this Court's decisions in *United Gas Pipe Line Co.* v. *Mobile Gas Service Corp.*, 350 U. S. 332 and *Federal Power Commission* v. *Sierra Pacific Power Co.*, 350 U. S. 348, 355, as requiring that there be added to the findings which the Commission must make, in order to reduce a contract rate found excessive, the further finding that the excess would also adversely affect "the financial ability of the public utility" purchasing the power "to continue its service." Indeed, it is apparent that acceptance of this contention would result in allowing two utilities to set any rate they choose by agreement, perhaps on the value-of-service principle as here, or any other basis. The Commission would ordinarily not be able to find that the rate was so excessive as to prevent the purchasing utility from continuing to render service, since the latter can pass along the higher rates it pays in the rates it charges. Thus, contrary

to the explicit language in both of the cases relied on, such rates would in fact be immune from regulation.

In both the *Mobile* and *Sierra* cases, this Court was concerned with a unilateral rate increase filed by the seller in derogation of its own contract. In the *Mobile* case, the rate increase filing was accepted by the Commission and allowed to go into effect without suspension under Section 4 of the Natural Gas Act, 15 U. S. C. 717c. In the *Sierra* case, the rate increase was suspended and subjected to a proceeding under Section 205 of the Federal Power Act, which corresponds to Section 4 of the Natural Gas Act. The Commission allowed the increase, finding the rate still below the cost of service. While the Court, in both cases, held that the seller did not have a right to change its contract rate by unilateral action, it stated clearly that these holdings did not impair the regulatory power of the Commission over contract rates. In *Mobile*, it said (350 U. S. at 344):

> Our conclusion that the Natural Gas Act does not empower natural gas companies unilaterally to change their contracts fully promotes the purposes of the Act. By preserving the integrity of contracts, it permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry. * * * On the other hand, denying to natural gas companies the power unilaterally to change their contracts in no way impairs the regulatory powers of the Commission, for the contracts remain fully subject to the paramount power of the Commission to modify them when necessary in the public interest.

> The Act thus affords a reasonable accommodation between the conflicting interests of contract stability on the one hand and public regulation on the other.

In *Sierra*, the Court said (350 U. S. at 353):

> * * * The Commission has undoubted power under § 206 (a) to prescribe a change in contract rates whenever it determines such rates to be unlawful. * * *
>
> The condition precedent to the Commission's exercise of its power under § 206 (a) is a finding that the existing rate is "unjust, unreasonable, unduly discriminatory or preferential." * * *

This is precisely what the Commission did here under Section 206 (a) of the Power Act. It reviewed the contract rate filed by petitioner, found it unreasonably high, and prescribed a new rate.

In the *Sierra* case, the Court also found that a contract rate is not invalid solely because it yields less than a fair return on invested capital, for a public utility could agree to such a contract and would not be entitled to be relieved of an improvident bargain except where the rate was so low as to affect the public interest adversely "as where it might impair the financial ability of the public utility to continue its service" (350 U. S. at 355). The Court added that, since the Commission's duty under Section 206 (a) of the Power Act is to protect the public interest, as distinguished from the private interest of the utilities, "it is clear that a contract may not be said to be either 'unjust' or 'unreason-

able' simply because it is unprofitable to the public utility" (350 U. S. at 355). It is evident, as the Commission and the unanimous court below recognized, that this Court was not attempting to prevent regulation of contract rates, as petitioner contends, but was only protecting consumer interests and that the *Sierra* holding can have no application where, as here, the contract rates are found unjust and unreasonable—because excessive—and consequently an unwarranted burden on the ultimate consumer. Having found the contract rate unreasonably high, the Commission was required by statute to fix the just and reasonable rate for the benefit of the ultimate consumer.

2. There is no conflict with the decision in *Montana-Dakota Utilities Co.* v. *Northwestern Public Service Co.*, 341 U. S. 246, as claimed by petitioner (Pet. 13–15). That case simply reiterated the principle that, when a court passes on rates fixed by a regulatory commission, the rates will not be upset by the court if they come within a "zone of reasonableness." *Federal Power Commission* v. *Natural Gas Pipeline Co.*, 315 U. S. 575, 585–586. But there is no basis for petitioner's assertion that the *Montana-Dakota* case requires the Commission (as distinguished from the reviewing court) to exercise a similar latitude in determining whether contract rates are unreasonable. Indeed, it seems clear that the Commission may set aside as unreasonably high any rate which is not the lowest reasonable rate because it produces more than a proper rate of return. Cf. *Federal Power*

Commission v. *Natural Gas Pipeline Co.*, 315 U. S. 575, 586.[2]

Moreover, petitioner makes no criticism of the method used by the Commission in determining the rate of return or any assertion that the 5.55 percent rate of return used by the Commission was unreasonable, but simply complains that the Commission did not compute the rate of return produced by the existing contract rates and then did not find that that rate of return was outside a "zone of reasonableness" which petitioner assumes to exist. In this connection, petitioner notes that it had contended before the Commission that 6 percent was a fair rate of return and that the presiding examiner had supported this position. Petitioner fails, however, to point out that, on the basis of the Commission's findings of the cost of service to Georgia Power Company, the contract rate produces a rate of return of 6½ percent,[3] which

[2] Petitioner's reliance on *Memphis Light, Gas and Water Division, et al.* v. *Federal Power Commission* (C. A. D. C. No. 13666, decided November 21, 1957), pending on writs of certiorari, No. 691, 694, 695, this Term, is also misplaced. The footnote to which petitioner refers (Pet. 15) is not part of the holding of the Court of Appeals, but rather an extra aside of two members of the court, which, as we show in our petition in the *Memphis* case (No. 694, this Term, pp. 25–26), is an incorrect statement of the Commission's practice. It has no application where, as here, the Commission has found that the contract rate is unjust and unreasonable.

[3] The Commission found that the contract rate to Georgia Power Company would produce revenues of $3,247,700, or $252,186 in excess of the cost of service. Included in the cost of service was the return of 5.55 percent or $713,241 (1 R. 116, 118). Thus, if the contract rate were allowed, the return would be the sum of $713,241 return allowed by the Commis-

is in excess of the 6 percent that petitioner claimed to be a reasonable rate of return. Thus, even if petitioner's "zone of reasonableness" argument had any merit in the abstract, which we deny, it could have no application in the circumstances of this case.

3. Contrary to petitioner's bald and unexplained assertion that the record contains no evidence at all to support the three findings of the Commission for which the majority of the court below seeks further explanations on remand, we submit that, as Chief Judge Parker stated in his dissenting opinion, the challenged findings have ample support in the record as it now exists without the need for further explanation or clarification. But even accepting the majority's view that such explanations are appropriate, the issues raised relate to the proper exercise of the Commission's discretion, not to the bare existence of substantial evidence; and, in any event, it seems clear that until the court below has finally disposed of these issues, all of which depend on the peculiar circumstances of this case, review by this Court is unwarranted.

(*a*) Petitioner has objected to the Commission's calculation of income taxes in determining the cost of service because the Commission made allowance only for the taxes payable by petitioner as a separate corporate entity. The Commission computed petitioner's income taxes by deducting the interest paid

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sion and the excess of $252,186, less $131,137 (52%) for federal income tax, or a total of $834,290. This is about 6½ percent on the total rate base of $12,851,181 (1 R. 118).

on its 90 percent debt capitalization, while petitioner would have its income tax allowance computed at the higher figure which would result if its debt ratio were the same as that of the system as a whole. Petitioner's argument has been that its parent, E & G, was forced to issue more common stock to offset the high debt ratio of the subsidiary so that it did not have as large an interest deduction as it otherwise would, and hence paid a higher tax. Thus, petitioner argues that the Commission must compute taxes on a system basis. Petitioner would have the Commission disregard the fact that it was deliberately set up as a separate corporation for the benefit of the parent, that it is operated as a separate entity, and that the service rendered to Georgia Power is not service performed by the system but by petitioner alone. The establishment of petitioner as a separate entity resulted from the parent company's desire to serve the Atomic Energy Commission project. When parent E & G's first offer of a rate to duPont was rejected as too high, it was necessary to develop a financing scheme that would enable the quotation of a lower rate. The 90 per cent debt financing which was adopted was satisfactory for this purpose, but a separate corporation had to be established because of E & G's financial necessities, particularly restrictions in its bond indenture against such high debt financing. To achieve its ends, E & G thus became not the operating company but an investor in petitioner which owns and operates the Urquhart plant. By setting up this separate

corporation, E & G, as the record shows, succeeded in acquiring duPont as a customer, benefiting its territory, and preventing the incursion of public power. In addition, under its contract with Georgia Power, the service rendered by petitioner is only that available from one-half the capacity of the first two units in the Urquhart station, each amounting to 75,000 kw. Unlike petitioner's contract with duPont, the contract with Georgia Power provides for no "back up" of capacity by the E & G system, which means that Georgia Power would be entitled to no power if none were available from the two particular units. While E & G may also have assumed certain burdens because of the utilization of this corporate device, these considerations give support for the Commission decision to determine income taxes on the basis of petitioner's capitalization ratio. Discussing petitioner's contention in this respect, the Commission said (1 R. 109):

> * * * With regard to the income tax allowance, Generating Company uses a hypothetical system capitalization ratio instead of its own actual ratio in order to erase the effect of higher tax costs which E. & G. Co. may incur as a result of the heavy debt financing of Generating Company. This is an attempt to enjoy the benefits of the high-debt financing, i. e., the construction of low cost capacity and the consequent sale to duPont, while making Georgia Power Company and ultimately the consumers in Georgia assume fictitious costs. As such, the allowance proposed by Generating Company is unreasonable.

> We have consistently held that the allowance for taxes should not exceed taxes paid. * * * Accordingly, the income tax allowance in this proceeding should be based upon the actual interest deduction of the Generating Company for that is the basis upon which it will pay its taxes.

Even though the Commission found that the record did not enable it to attribute a precise value to the disadvantages that may have accrued to the parent company as a result of petitioner's high debt financing, these were expressly taken into consideration by the Commission when it permitted the rate of return to be computed on the basis of the capital structure of the E & G system, rather than petitioner's (1 R. 105–106). In addition, as Chief Judge Parker points out, the use of the system capitalization ratio for the purposes of the rate of return, even if it were inconsistent with the use of the company ratio for income tax purposes, could only accrue to the benefit of the petitioner (Pet. App. A 29).

(*b*) As all members of the court below recognized, the modification of the escalation clause in the capacity charge of the contract is a matter for the informed judgment of the Commission. The majority of the court held, however, that the Commission's finding in this respect failed to explain its action. This escalation clause provides for adjusting the capacity charge to reflect changes in working capital, additions to plant, amount of taxes paid, administrative and general expenses, and expenses for operating super-

vision and labor.[4] But these escalation provisions fail to take into account changes in an important element of the capacity cost, namely, the effect of the decline in the rate base due to the increasing reserve for depreciation. The Commission realized that the escalation provisions would clearly tend to favor rate increases rather than decreases, stating (1 R. 137):

> * * * With regard to the escalation clauses affecting the capacity component, it should be noted that the capacity component of the rate to Georgia Power Company is based upon recovery of capacity costs associated with the output of one-half of the total capacity available from two 75,000 kw generators at Plant Urquhart. Confronted with this relatively stable capacity cost situation, the primary problem is not the recovery of unknown and conjectural increases in capacity costs which might occur, but the maintenance of a just and reasonable rate under conditions of a declining rate base. Under these conditions it is probable that the regulatory lag would work more to the seller's benefit than to its detriment.

For this reason, the Commission prescribed a capacity charge which would be fixed except for an adjustment with respect to any increase or decrease in the Federal income tax and required petitioner to eliminate the provisions in the contract which would have the effect of binding the parties to file rate increases without consideration of the declining rate base. It

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[4] Changes in expenses for fuel, maintenance, and related taxes are reflected in the energy charge escalation provisions which the Commission left unchanged.

would appear that the quoted passage shows that, on the record as it now stands, there was no abuse of the Commission's discretion, or, at the least, that a remand is appropriate instead of a reversal. In any event, we do not understand the relation of the substantial evidence rule to this phase of the remand.

(*c*) Petitioner has also urged that the funds invested by E & G in the Urquhart plant during its construction had cost 10 percent so that, during the period of construction, interest on these funds should have been allowed at the rate of 8 percent for the purpose of inclusion in petitioner's rate base rather than the Commission's allowance of 6 percent. In its opinion, the Commission recognized that E & G's investment during construction should be allowed a reasonable rate of interest for the period of construction but added that petitioner should not be permitted to capitalize profits on investment before commercial operation of the plant has begun (1 R. 112). The majority of the court below felt that this did not explain why an element of cost actually experienced should not be included in the rate base, but the majority failed to recognize that the cost of the equity funds was a cost incurred by E & G rather than by petitioner. The basis of the Commission's action is that it is allowing interest on E & G's investment, at a generous rate, but not a return of profits until the plant is in operation. In allowing 6 percent on E & G's equity funds, the Commission was acting in accordance with its Uniform System of Accounts and its past practice which has received judicial ap-

proval. *State Corporation Commission* of *Kansas* v. *Federal Power Commission,* 206 F. 2d 690 (C. A. 8), certiorari denied, 346 U. S. 922. These factors show that there is no basis for petitioner's assertion that the record could not possibly support findings by the Commission on this aspect of the case.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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APPENDIX

The Federal Power Act, 49 Stat. 838, 847, 16 U. S. C. 791a, *et seq.*, provides in pertinent part:

SEC. 205. * * *

(c) Under such rules and regulations as the Commission may prescribe, every public utility shall file with the Commission, within such time and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection schedules showing all rates and charges for any transmission or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any public utility in any such rate, charge, classification, or service, or in any rule, regulation, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint or upon its own initiative without complaint, at once, and, if it so orders, without answer or formal pleading by the public utility, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the public utility affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of such five months, the proposed change of rate, charge, classification, or service shall go into effect at the end of such period, but in case of a proposed increased rate or charge, the Commission may by order require the interested public utility or public utilities to keep accurate account in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts are paid, and upon completion of the hearing and decision may by further order require such public utility or public utilities to refund, with interest, to the persons in whose behalf such amounts were paid, such portion of such increased rates or charges as by its decision shall be found not justified. At any hearing involving a rate or charge sought to be increased, the

burden of proof to show that the increased rate or charge is just and reasonable shall be upon the public utility, and the Commission shall give to the hearing and decision of such questions preference over other questions pending befor it and decide the same as speedily as possible.

SEC. 206. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint, shall find that any rate, charge, or classification, demanded, observed, charged, or collected by any public utility for any transmission or sale subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

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